



THE CITY OF SAN DIEGO

M E M O R A N D U M

DATE: March 8, 2010

TO: Eduardo Luna, City Auditor

FROM: Mary Lewis, Chief Financial Officer

A handwritten signature in cursive script that reads "Mary Lewis".

SUBJECT: Management Response to the *Citywide Revenue Audit Report*

This memorandum is in response to the City Auditor's Citywide Revenue Audit Report (Report). City staff received the final version of the Report on February 17, 2010, with final changes based on management's discussions with City Auditor received on March 4, 2010. While the City Auditor released his Report on Friday March 5, 2010 without management's response, under the internal controls and process narrative reviewed by the City Auditor, management has 30 days to prepare their response and present it to the City Auditor, which would have been March 19, 2010.

The Audit Report on Citywide Revenue (Report) finds that most major revenues are audited and points out areas of improvement where departments can streamline communication with the County and enhance or develop the documentation of processes and procedures in the current review of City revenues. Management supports these process improvement recommendations, some of which are currently underway and which will be completed according to the dates in the responses listed below.

The Report identifies little quantifiable data to indicate that revenues are being left on the table through lack of additional auditing activity. Since there is no excess capacity in the finance department, the assessment of cost versus return on potential incremental revenue will need to be conducted in the next year to determine how to proceed with several of the recommendations to benefit the City overall.

The Report did not take a position on where the Revenue Audit Division should report. The division currently reports to the City Treasurer, and has been highly effective in revenue recovery (**Attachment 1**). This division should remain in that Department since it is a function of the City Treasurer to collect all revenues owed to the City.

The San Diego City Charter Section 45 requires that the City Treasurer shall collect taxes, fees and assessments and maintain and inspect records and accounts:

The Treasurer shall issue notices for and collect...miscellaneous taxes, fees, assessments, licenses and privilege charges as may from time to time be assigned to him or her. He or she shall maintain a continuous inspection of the records and accounts of such taxes, licenses and privilege charges in order to effectuate their collection.

In 2006, City management made the decision to move the external audit function from the City Auditor and Comptroller Department to the Office of the City Treasurer. This move was supported by the Kroll Report recommendation that the City create a new independent position of Auditor General with responsibility for **internal** audits of the City's (1) internal controls; (2) financial accounting, reporting and disclosure; (3) operations; and (4) fraud, waste and abuse. Significant efficiencies have been realized as a result of the Revenue Audit Division existing within the Department which, as required by City Charter, administers the City's tax codes and receives lease and franchise fee payments on behalf of administering departments.

The Office of the City Treasurer, Financial Management Department, Office of the City Comptroller, Real Estate Assets Department and General Services Department have reviewed the February 2010 *Citywide Revenue Audit Report* and provide the following responses to the recommendations:

Recommendation 1: *Develop a Memorandum of Understanding with the County of San Diego to ensure access to required information allowing the City Treasurer's Revenue Audit Division to review property tax allocations to the City and observe the next State audit of the County*

Response: Agree with recommendation. A survey will be performed during the first quarter of Fiscal Year 2011 to determine whether other jurisdictions have performed similar property tax allocation audits. The purpose will be to determine the staffing needed and estimate the revenue potential to the City. If the survey suggests such an audit would be beneficial to the City, the Revenue Audit Division will work with the Financial Management Department to develop a Memorandum of Understanding with the County of San Diego that enables the City to review property tax allocation information.

Recommendation 2: *The Financial Management Department should take steps to obtain State audits of County property tax allocations, and review any relevant findings/recommendations for purposes of follow up.*

Response: Agree with recommendation. Financial Management will contact the State Department of Finance in April to obtain audit findings from previous fiscal years for review. Financial Management will also contact the State by August 31st to discuss receiving audit reports for the County of San Diego's property tax allocations for fiscal year 2010.

Recommendation 3: *The City Treasurer's Office should consider providing business registration information to the County Assessor's Office, and inform new businesses registering in the City of San Diego that they may be required to pay unsecured property tax to the County.*

Response: Agree with recommendation. The Office of the City Treasurer Business Tax Division currently provides a listing of businesses on its website at:

<http://www.sandiego.gov/treasurer/taxesfees/btax/nblactive.shtml>

The City of San Diego uses State income tax data to ensure full compliance of businesses located and operating within City limits. By the end of the fourth quarter of fiscal year 2010, the City will request that the County match the City's Business Tax data against the County's unsecured property database and extract businesses that are not in compliance.

In addition, the City Treasurer will request the County's unsecured property reporting requirements literature and place it in the lobby information center. The Office of the City Treasurer will provide the Office of Small Business additional detail regarding the County's unsecured property tax requirements to add to its *"10 Key Steps" to Starting a Business* publication. (Newly formed businesses use this information as a guide to local, state and federal business start-up regulatory requirements).

These measures could increase the amount of unsecured property tax to the City, and an analysis will be conducted 12 months after these outreach and education activities are in place to determine any material effect on unsecured property tax revenues.

Recommendation 4: *The City of San Diego should consider streamlining its communication with the County of San Diego's Assessor's Office to ensure the County's possessory interest records are up to date.*

Response: Disagree with the recommendation. The Real Estate Management Assets Department (READ) has streamlined communications with the County for **all** City owned land. READ sends a report twice yearly to the County Assessor that lists all of the possessory interests in City owned property. Any questions or anomalies are discussed directly by phone with the Assessor's office. The Report's request for consolidation of communication is unclear since there is one point of contact for the City's possessory interests.

Recommendation 5: *The City's Financial Management Department should evaluate the benefits of joining the Teeter Plan, and unless there is compelling information to suggest otherwise, take appropriate steps to become part of the Plan.*

Response: Agree with recommendation. As stated in the City's Internal Auditor report, a cost and benefit analysis of joining the Plan based on lost revenues and increased cash flow for previous fiscal years is difficult to accurately perform due to the lack of information from the County Assessor and Auditor's Offices. A number of different analyses have been prepared by the Auditor's Office, Financial Management, and the County with different estimates of increased cash flow and lost revenue estimates if the City were to join the Teeter Plan (Plan). The estimates prepared by the County showed a cash flow improvement to the City of San Diego

of approximately \$10 million per fiscal year from 2007 – 2010. However, the assumptions the County used to estimate these cash flows and penalties referenced in the Report are unclear or unknown.

In that regard, a statement made in the Report regarding the City's property tax revenues cannot be verified at this time and is premature and potentially misleading.

The Report states:

"The San Diego County's Property Tax Service Division's own analysis revealed that the impact of not receiving revenues as part of the Teeter Plan resulted in the city not receiving \$29.7 million in realized property tax revenues, which were generated in the past three fiscal years".

The \$29.7 million cited in the Report overstates the delayed receipt of property tax revenue and is misleading since it does not consider that the City, as a non-participant in the Plan, also receives an inflow of property tax revenues each year from the collection of prior year delinquencies (with associated penalties and interest.) The Report's analysis is flawed in not considering this inflow of revenue offsetting delayed cash flow from the annual uncollected tax levy. The City's total property tax revenue in any year is augmented by prior year revenues and the delay in receipt of the annual levy that is uncollected that year may be offset in great part - or be exceeded - by prior year revenues flowing into the City. The County has not yet provided the data to either management or the City Auditor showing the revenue stream from the collection of prior year delinquencies. This is critical information for any definitive analysis and management will request this information from the County.

In addition, the Report analyzes data the County provided as if the City were in the Teeter Plan. Since the City is not in the Plan, a very different data set and analysis is needed than the information presented in the Report to determine accurately the economic impact to the City by joining Teeter.

The Teeter Plan allows Cities to receive their full property tax amounts due in the fiscal year in which they were billed to property owners. Any amount of property tax that is due to the City at the end of a fiscal year from an unpaid secured property tax amount is paid to the City by the County. The County benefits by keeping the City's allocated penalties and interest, which are approximately 15 percent of the unpaid tax bill. Additionally, since these unpaid bills are secured by real property, this payment is virtually guaranteed by the ability of the County to foreclose on a property that has five years of unpaid property tax bills. A city that is not a participant in the Plan does not realize a cash flow benefit but keeps all penalties and interest associated with the unpaid bills. Therefore, a non-participant in the Plan receives more revenue than a participant in the Plan, in exchange for delayed cash flow.

During periods of economic downturn, such as the one currently being experienced, these delinquent property tax receivables due to the City increase as fewer homeowners are able to pay amounts currently due. However, with an increase in receivable property tax amounts, a corresponding increase in receivable penalty revenue occurs. During times of economic expansion, these delinquent property tax amounts and the associated penalty and interest revenue are paid, resulting in additional income received by a city that is not a Plan participant. With the

forecasted economic stabilization and growth in the upcoming fiscal year(s), the City of San Diego could lose additional revenue in exchange for an improved cash flow.

Financial Management will work with the County of San Diego Auditor's Office over the next six months to obtain more information about the benefits or loss associated with the City joining the Teeter Plan. Some of the additional questions that the County will be asked include: Would the City receive the accrued penalties and interest, or only the delinquent tax amount? How much if any delinquent revenue would be lost to the City from prior years by joining the Plan? Further research and analysis will be performed by Financial Management to verify the amount of potentially improved cash flow or the decrease in revenues from losing interest and penalties, any potential increase in administrative costs for the City, and other factors that may affect the City's decision to join the Plan. A report and recommendation on the Teeter Plan will be presented to the Budget and Finance Committee in the second quarter of fiscal year 2011.

Recommendation 6: *Consider having the City Treasurer's Revenue Audit Division utilize the free audit training offered by MuniServices, LLC to reduce reliance on MuniServices for future sales and use tax audit services.*

Response: Partially agree with recommendation. A cost-benefit analysis of changing the distribution of sales tax audit responsibilities will need to be performed to determine the reasonableness of the City taking on this role. This analysis will be performed before the current MuniServices agreement expires in April 2011. If the analysis suggests the City can increase its sales tax revenue recovery through increased involvement in the sales tax audit process, this training will occur. However, while management will explore the enhancement of audit services through additional training, we do not believe that it is cost effective or beneficial for the City to bring in-house the full sales tax and property tax revenue auditing function performed by an outside firm with specialized expertise.

Recommendation 7: *Financial Management should review gross Safety Sales Tax revenues annually in order to verify the accuracy of Safety Sales Tax allocations to the City.*

Response: Agree with recommendation. Financial Management reviews both monthly and annually the distributions of safety sales tax (Proposition 172) using information from the California State Controller's web site, which outlines distributions to individual counties throughout the State. This information is used in combination with the City's distribution percentage of total County revenue (3.2 percent), as established by California government code 30055 (d), for correct allocation review.

The gross amount of safety sales tax revenue received by the State is apportioned to each county based upon the county's total taxable sales as a percentage of State-wide taxable sales. Financial Management will request State-wide taxable sales amounts and total County of San Diego taxable sales amounts from the State Board of Equalization by August 1st to determine if the gross amount of Proposition 172 revenue received by the County prior to distributions to cities is correct. Financial Management will also request the County provide their audit, if available, of the gross amount of revenue received by the state.

Recommendation 8: *FM should annually reconcile Sales Tax Triple-Flip funds received from the County with ERAF shift loss detailed in BOE sales tax reports.*

Response: Disagree with recommendation. FM currently reviews **quarterly and reconciles annually** the Sales Tax Triple-Flip funds received from the County with ERAF shift loss detailed in BOE sales tax reports.

It is unclear from the recommendation in the Report what additional review is recommended.

In addition, the Report states: "...the County is responsible for the calculation of the Educational Revenue Augmentation Fund shift **that determines the sales tax amount the City exchanges for an equivalent amount of property tax.**" The highlighted portion is not correct because the State Department of Finance provides the triple flip allocation calculations to counties with specific allocations for each city within that county. The county does not determine the allocation to the cities; that information comes to the counties from the BOE.

Recommendation 9: *The City Comptroller's Office should continue indentifying the necessary sub processes and prepare written policies/procedures for verifying the accuracy of TransNet revenue.*

Response: Agree with recommendation. The Office of the City Comptroller and Financial Management have identified six separate TransNet process narrative documents that are scheduled to be written and published during the first quarter of fiscal year 2011.

Recommendation 10: *In order to verify accurate TransNet allocations, the City of San Diego Streets Division should work with the California Department of Transportation (CalTrans) to ensure accurate miles of road maintained figures".*

Response: Agree with recommendation. Street Division will continue to work with Caltrans to ensure accurate miles of street maintained figures. Currently Street Division is reviewing the 2009 mileage report provided by Caltrans and will ensure all City maintained street miles are accurately reflected in the Caltrans mileage report. The review and update of the mileage is expected to be completed by the last quarter of fiscal year 2010.

Recommendation 11: *The Office of the City Comptroller should develop written policies/procedures for verifications of gas tax revenues performed by the City.*

Response: Agree with recommendation. The Office of the City Comptroller will develop a process narrative that documents the requirements for verification of gas tax revenues. This process narrative(s) will be written and published during the first quarter of fiscal year 2011.

Recommendation 12: *The Office of the City Comptroller should ensure the City is not paying federal gas taxes by verifying that the payments to fuel vendors do not include federal excise tax.*

Response: Agree with recommendation. The Office of the City Comptroller will develop a process narrative that documents the requirements for verification of not paying for federal

excise tax on purchased fuel. This process narrative will be written and published during the first quarter of fiscal year 2011.

Recommendation 13: *The Office of the City Comptroller and Financial Management should develop written policies/procedures for verifications of motor vehicle license fees.*

Response: Agree with recommendation. The Office of the City Comptroller and Financial Management will develop a process narrative that documents the requirements for verification of motor vehicle license fees. This process narrative(s) will be written and published during the first quarter of fiscal year 2011.

Recommendation 14: *The City Treasurer's Office should monitor when court revenue distribution audits are done by the State Controller's Office, and be aware of findings and/or under remittances relevant to the City of San Diego for purposes of follow up.*

Response: Agree with recommendation. The City Treasurer's Office will establish a written departmental procedure for monitoring distribution audits by the first quarter of fiscal year 2011.

Recommendation 15: *The City Treasurer's Revenue Audit Division should consider performing audits of court distributed revenues.*

Response: Partially agree with recommendation. Cost-benefit analysis will be performed before taking on this role. This analysis will involve determining which court distributed revenues are subject to outside audit; which court distributed revenues are large enough to merit the cost associated with audit; the likelihood that, and extent which, court distributed revenues have been underpaid to the City; an estimate of the time needed to conduct these reviews; the ability to perform such reviews with existing staff, and, if existing staff is not sufficient, the cost of adding staff to the division. This cost-benefit analysis will be completed by the end of the second quarter of fiscal year 2011.

Recommendation 16: *The Office of the Independent Budget Analyst (IBA) should work in consultation with the Real Estate Assets Department to revise Council Policy 700-10 to clarify who has the appropriate auditing authority.*

Response: Agree with recommendation to revise the Council Policy. READ will work with the IBA in order to clarify Council Policy 700-10 to reflect that the Office of the City Treasurer's Revenue Audit Division has auditing authority. Real Estate Assets believes that this can be completed by the end of the first quarter of fiscal year 2011.

Recommendation 17: *The Real Estate Assets Department should develop written policies/procedures for the verification of lease payments.*

Response: Agree with recommendation. The Real Estate Assets Department will develop written procedures in conjunction with the new Reportfolio data management system that will be implemented by Real Estate Assets on March 1, 2010. This should be completed by the end of the first quarter of fiscal year 2011.

Recommendation 18: *The Real Estate Assets Department should work with the City Treasurer's Revenue Audit Division to develop an indicator for percentage leases in the Electronic Document Retrieval System (EDRS).*

Response: Partially agree with the recommendation. We agree that the Revenue Audit Division should have a process of determining percentage leases in the Reportfolio data management system. The Revenue Audit Division will have access to Reportfolio which will have indicators for percentage leases. However, the Electronic Document Retrieval System is a document storage system and not a data management system; therefore, it would not be practical to place percentage lease indicators in this system. A new process will be documented and completed by the end of fiscal year 2010.

Recommendation 19: *The City Treasurer's Revenue Audit Division should include their annual reconciliation of the Division's lease audit database with the Real Estate Assets Department database in their written departmental procedures.*

Response: Agree with recommendation. The departmental procedure will be completed by the end of the third quarter of fiscal year 2010.

Recommendation 20: *The Revenue Audit Division should develop policies/procedures for auditing state video franchises that include (1) procedures for auditing franchisee's methodology of calculating franchise fees, (2) the requirement for the franchisee to provide detailed calculation summaries, and (3) an audit cycle no longer than 4 years.*

Response: Agree with recommendation. These are all standard audit procedures that will be incorporated into the audit program for state video franchises when it is developed and completed in the fourth quarter of the current fiscal year.

Recommendation 21: *Based on the requirement for hotel operators to maintain records for a period of three years, the Revenue Audit Division should perform audits on a three-year cycle.*

Response: Disagree with recommendation. The recommendation restates the documented procedures already in place in the City Treasurer's Department. As stated in the Office of the City Treasurer Departmental Procedure regarding the determination of the audit cycle, TOT audits are currently scheduled to be performed between every two to three years. The Revenue Audit Division will continue to abide by its Departmental Procedures.

Recommendation 22: *The Business Tax Compliance Program should develop written policies/procedures for the work it performs.*

Response: Agree with recommendation. The Business Tax Compliance Program policies and procedures that are currently being drafted will be finalized to include the Franchise Tax Board process. This will be completed by the end of the fourth quarter of Fiscal Year 2010.

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Recommendation 23: *The Business Tax Compliance Program should expand techniques used for ensuring compliance – including utilization of preventative measures such as informal employee audits – and determine an alternative method for ensuring accurate business size designation.*

Response: Agree with recommendation. The Office of the City Treasurer is currently evaluating an employee count verification process requiring businesses with five or more employees to submit their State of California annual EDD tax statement to confirm employee count compliance with the City's Business Tax requirement to report number of employees. This proposal for fiscal year 2011 has been drafted and submitted. If approved, it is estimated that this program could be implemented by the end of the first quarter of Fiscal Year 2011.

Mary Lewis
Chief Financial Officer

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Attachment: 1. Revenue Audit Quarterly Reports: FY2009 Quarter 3 and Quarter 4;
FY2010 Quarter 1 and Quarter 2

cc: Honorable Mayor Jerry Sanders
Honorable Councilmembers
Jay M. Goldstone, Chief Operating Officer
Wally Hill, Assistant Chief Operating Officer
Gail Granewich, City Treasurer
Nader Tirandazi, Financial Management Director
Ken Whitfield, City Comptroller
Jim Barwick, Real Estate Assets Director
Mario Sierra, General Services Director
Kyle Elser, Audit Manager